Stepan Company

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**Investment Summary**

Stepan Company was founded in 1932 by Alfred C. Stepan Jr. and is currently headquartered in Northfield, Illinois with approximately 1800 employees. Stepan manufactures basic and intermediate chemicals, including surfactants which according to their self-description they are the largest global manufacturer of, specialty products, germicidal and fabric softening quaternaries, phthalic anhydride (P.A.), polyurethane polyols and special ingredients for the food, supplement and pharmaceutical markets. Recently, Stepan has been focusing on mergers and acquisitions as part of their strategy is to acquire new firms and generate half of their sales from acquisitions both domestic and international. That being said, on July 20th 2016 Stepan announce its agreement to acquire a commercial business from Tebras and a sulfonation production facility from PBD in Brazil with a combined annual sale amount of approximately $32 million dollars and a capacity of 25,000 metric tons of sulfonation production. President and CEO Quinn Stepan Jr. expects the acquisition to expand and diversify their customer base for not only sulfonated products in Brazil but also provide an opportunity to broaden their surfactant portfolio to more than 1200 new customers.

 We have evaluated and forecasted the earnings for Stepan Company both from a quarterly perspective as well as a yearly perspective. Evaluating the quarterly earnings, we noticed that Stepan this year (2016) has had the highest quarterly earnings for quarters one and two beating the six year Quarter one and two average by $8.5 million and $7.3 million dollars respectively. Its third quarter earnings are on par with the average while a forecast of quarter 4’s earnings would forecast the total earnings of 2016 at $90.5 million dollars. Also the highest in the past six years. Taking a look even further into 2017 and we have quarterly earnings that are forecasted to be above their respective averages totaling to a yearly forecast of $82.3 million dollars which would be the second highest in the last six years assuming our fourth quarter forecast for 2016 is correct or a minimum earning of $3.5 million dollars during this quarter which is well below the quarter four average of

$11.1 million.

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| --- | --- |
| 2017 Q1 forecast |  $ 22,534.16  |
| 2017 Q2 forecast |  $ 22,291.77  |
| 2017 Q3 forecast |  $ 22,459.10  |
| 2017Q4 forecast |  $ 15,012.08  |
| 2017 yearly forecast |  $ 82,297.11  |

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| --- | --- |
| 2016 q1-3 earings  |  $ 75,946.00  |
| 2016 q4 forecast | 14562.6913 |
| 2016 forecast |  $ 90,508.69  |

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| --- | --- |
| Year | earnings |
| 2010 |  $ 65,427.00  |
| 2011 |  $ 71,976.00  |
| 2012 |  $ 79,396.00  |
| 2013 |  $ 72,828.00  |
| 2014 |  $ 57,101.00  |
| 2015 |  $ 75,968.00  |
| 2016 |  $ 90,508.69  |
| 2017 |  $ 82,297.11  |

**Forecasted Quarterly Earnings**

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| --- | --- |
| Avg Qt Earnings |  $ 18,468.22  |
| avg Q1 earnings |  $ 19,174.17  |
| avg Q2 earnings |  $ 20,557.83  |
| avg Q3 earnigns |  $ 19,572.33  |
| avg Q4 earings  |  $ 11,145.00  |

\*Highlighted Numbers are forecasted

As you can tell from our quarterly earning analysis, Stepan’s fourth quarter earnings have historically been lower than any other quarter throughout any year. This year is no different, with our forecast model predicting their fourth quarter earnings to be about 14.5 million which is 10.7 million lower than the average for the first three quarters of 2016 thus far. That being said, given the hisotrical fourth quarter earnings and our forecast, we are predicting that the market will react to the lower earnings in a negative way thus lowering the stock price to a point where we would recommend buying it. At this point however we are recommending a hold strategy until the fourth quarter earnings are released. Once the fourth quarter earings are made public, If the strock price drops to a price of about $65-70 we would recommend buying the stock. However if the price drops below $65 we would not recommend buying it as the market has overreacted to the quaterly earnings decrease. We do however believe that because of conservatism bias, the market will be slow to fully react to the earings release thus creating a mispriced match which we could exploit by purchasing the stock between if it drops to a price range of $65-$70 from where it currently is at today a price of $82.

**Business Description**

As we’ve mentioned before, Stepan is a major global manufacturer of specialty and intermediate chemicals that are used in a broad range of industries. They manufacture not only a wide range of cleaning products but they also manufacture surfactants, polymers and specialty goods such as food and pharmaceuticals.

Surfactants which are key ingredients in consumer and industrial cleaning compounds such as detergents, cleansing or wetting agents, emulsifiers, foaming or defoaming agents, viscosity builders, degreasers as well as dispersants are Stepan’s number one product and they are the world’s largest merchant producers of surfactants with sixteen manufacturing locations worldwide. Their competitive advantage not only comes from economies of scale from being the world’s largest producer but they also pioneered and developed the continuous falling film sulfonation process which yields high-quality surfactants in a variety of concentrations allowing them to meet the needs of their customers from various markets.

Stepan’s second biggest product category include polymers and it is a global leader in the production and sale of polyester polyols, specialty polyurethane foam systems and phthalic anhydride. Stepan offers a full range of polyester polyols for use in rigid foams that are commonly used in spray and appliance insulations among other uses as well as flexible foams whose end use are common in furniture and bedding; filtration for air and fluids in consumer, medical as well as industrial applications and automotive foams. Their polyester polyols are also used in coatings, adhesives, sealants and elastomers. Their competitive advantage when it comes to polyester polyols come from their vertically integrated supply chain, along with a global network of manufacturing plants that allows them to deliver the highest quality and consistency.

Stepan’s specialty products mainly deal with nutrition as its Lipid Nutrition business is a leading global producer of patented, science-based nutritional oils used in the food, nutrition as well as pharmaceutical industries. Their products included in the nutrition market segment involves infant nutrition, weight management as well as sports nutrition. Stepan encourages customer involvement across all critical function including R&D, supply chain, regulatory and marketing and makes it a top priority in order to deliver great quality product. Stepan’s competitive advantage in this market is its ability to involve their customers in every step of creating their product as well as some of the rights and patents that they own. For example, currently Stepan is the only company in the United States that is allowed to import cocoa leaves in order to manufacture both a coca leaf extract used by the Coca Cola Company in their coke beverage as well as to manufacture cocaine which is sold to Mallinckrofdt a pharmaceutical firm for medicinal purposes.

Stepan’s net sales came from three different product segments in surfactants which accounted for the majority of their sales at $1.2 billion for the year 2015 equating to 68% of total sales. Polymers were second with a total net sale amount of $491 million or 28% of total net sales. Last we had their specialty products with net sales of $78.8 million or just 4% of total net sales. Much of Stepan’s expenses come from their cost of sales as it average 85% of net sales over a three year period ranging from 2013-2015.

**Management & Governance**

F. Quinn Stepan, Jr. is the current Chief Executive Officer and has been since January 1, 2006 when he succeeded his father F. Quinn Stepan Sr. who is currently the chairman of the board. Mr. Stepan Jr. is also the president of the company a position he has held since 1999 when he was also elected as chief operating officer. Mr. Stepan Jr. has been with the Stepan Company for 29 years now dating back to 1987 when he joined the company as a general manager after working four years with the Monsanto Company. After serving as manager of the surfactant department the company’s largest segment, Mr. Stepan than became the vice president of that same department. Mr. Stepan Jr.’s father Stepan Senior also succeeded his late father in Alfred C. Stepan, Jr. who founded the company in 1982. F Quinn Stepan, Sr. has been with the company since 1961 and has served as Chairman and Chief Executive Officer from 1984 until his son took over in 2006. It was under Mr. Stepan, Sr.’s direction that the company expanded from its North American base to a global supplier of surfactants and polymer products. During this time period, Stepan also saw a substantial increase in its sales as they grew from $200 million in 1984 to over a billion dollars in 2005 his last year as chief executive officer.

 Mr. Stepan, Sr. plans on retiring at the end of this year on the 31st of December. The board of directors of Stepan have unanimously appointed Mr. Stepan, Jr to succeed his father once again this time as chairman of the board. Mr. Stepan Jr. effective January 1st 2017 will now be President, Chief Executive Officer as well as Chairman of the board. Because of Mr. Stepan Jr.’s other senior roles within the company, the board has also decided to appoint Mr. Edward J Wehmer as lead independent director. Mr. Wehmer is the President and Chief Executive Officer of Wintrust Financial Corporation a financial services company out of Rosemont, Illinois which he is also the founder of. Mr. Wehmer has served on the board since August of 2003. Because of the appointment of Mr. Wehmer, we can consider the board of directors to be semi-independent from the company. Although they have mostly independent directors as Mr. Stepan Sr. is the only director who also serves as a senior manager for the company, he holds a very significant and influential role within the board of directors thus giving him the ability to influence the entire board.

 Financially, Stepan Company is being led by Scott D. Beamer who’s been serving as Chief Financial Officer and Vice President since August of 2013. Mr. Beamer also serves as a Principal Accounting Officer. Prior to joining Stepan Mr. Beamer served as a Corporate Controller of PPG Industries. Under Mr. Beamer’s guidance, Stepan has decided to increase the amount of debt that they use to finance the company over the last three years as shown by their debt to equity ratio which has increased every year since 2013 where it was 1.1 to 1.17 in 2014 and now at 1.22 for the past year of 2015.

 In 2015 the most recent fiscal year, Mr. Stepan Jr had a total compensation package totaling $3.7 million. Of that amount only $800,000 is his base pay or 22%. About 36% ($1,332,392) was received as a bonus or non-equity incentive compensation. 15% (566,900) was awarded as stock while another 24% (899,994) was awarded in option value. The remainder 3% ($91,977) came from other forms of compensation. Currently according to Yahoo Finance about 13% of all stocks are held by insiders.

 Overall Stepan’s management team along with its board of directors have seem to be doing an incredible job managing the company as they’ve been able to expend and grow over the last few years. Furthermore, they have been able to withstand periods of turbulence in the stock market thus making them a great investment during financial downtimes.

**Industry Overview and Competitive Positioning**

 According to Yahoo, Stepan Company (SCL) has a relatively small number of competitors. These entities include Koppers Holdings Inc. (KOP), Air Products and Chemicals, Inc. (APD), and Huntsman Corporation (HUN) as their primary competitors. However, these competitors are classified by separate industries. Figure 1.1 exhibits the following competitive industries and total market capitalization.

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| --- | --- | --- |
| Tick: | Industry | Industry Market Cap |
| SCL | Cleaning Products | 48B |
| KOP | Specialty Chemicals | 2,919B |
| ADP | Chemicals – Major Diversified | 13,040B |
| HUN | Chemicals –Major Diversified | 13,040B |

Figure 1.2 represents a competitive analysis regarding these organizations.

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| --- | --- | --- | --- | --- |
| Tick: | SCL | KOP | ADP | HUN |
| Market Cap | 1.81B | 819.28M | 31.42B | 4.59B |
| Size relative to industry (%) | 0.037708% | 0.000028% | 0.00241% | 0.0000352% |
|  |  |  |  |  |

Products relative to competitors

 Stepan Company has a large spectrum of products that has many applications within the following market and industries. Agricultural products, antimicrobials, beverages, construction, dietary supplements, emulsion polymerization, flavors, food, household, institutional and industrial cleaning, industrial products, laundry and cleaning, nutrition, nutritional powders, oil field, personal care, pharmaceutical, phthalic anhydride, polyester polyols: C.A.S.E., polyester polyols: flexible foam, polyester polyols: powder coating resin, and polyester polyols: rigid foam.

 Koppers Holding products include the following: Carbon materials and chemicals, railroad products and services, and performance chemicals.

 Air Products and Chemicals products include: a wide range of gasses, chemicals much like Stepan company, and equipment to support gasses and chemicals they produce such as food freezers, oxy-fuel burners, and heat exchangers.

 Huntsman Corporation products include chemicals, plastics, detergent, personal care, rubber and packaging industries. Much of the chemicals and detergents are the same ingredients as Stepan Company’s.

SWOT Analysis:

*Stepan Company*

|  |  |
| --- | --- |
| Strengths | Weaknesses |
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| --- |
| Monetary assistance providedReduced labor costsExperienced business units |

 | Small business units |
| Opportunities | Threats |
| New acquisitionsIncome level is at a constant increaseNew products and services | External business risksGrowing competition and lower profitabilityFinancial capacityRising cost of raw materialsGovernment regulationsIncreasing rates of interestIncreasing costs |

*Koppers Holding:*

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| --- | --- | --- | --- |
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| **Strengths** |

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| **Weaknesses** |

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| Skilled workforceReduced labor costsHigh profitability and revenueDomestic marketExperienced business units | Future productivity |
| Opportunities | **Threats** |
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| --- |
| Growth rates and profitabilityGrowing economyNew acquisitionsNew products and servicesVenture capitalGlobal markets |

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| --- |
| Technological problemsExternal business risksRising cost of raw materialsGrowing competition and lower profitabilityIncrease in labor costs |

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*Air Products and Chemicals*

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| **Strengths** |

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| **Weaknesses** |

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| Existing distribution and sales networksHigh profitability and revenueHigh growth rateExperienced business unitsBarriers of market entry |

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| --- |
| Future cost structure |

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| **Opportunities** |

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| **Threats** |

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| Growth rates and profitabilityIncome level is at a constant increaseNew products and servicesNew marketsGlobal marketsGrowing demand | Government regulationsGrowing competition and lower profitabilityTax changesIncreasing costsIncreasing rates of interestIncrease in labor costsFinancial capacityPrice changes |

*Huntsman Corporation*

|  |  |
| --- | --- |
| Strengths | Weaknesses |
|

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| --- |
| Monetary assistance providedSkilled workforceExperienced business unitsBarriers of market entryExisting distribution and sales networksHigh growth rate |

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| --- |
| Future productivity |

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| Opportunities | **Threats** |
| Global marketsGrowing demandGrowth rates and profitabilityNew acquisitions | Financial capacityIncrease in labor costsGrowing competition and lower profitabilityTechnological problemsPrice changesIncreasing costs |

Product Market Overview:

 Surfactants Market Overview: “Surfactants Market is expected to garner $44.6 billion by 2020. The consumption of surfactants across the globe in 2014 was 17,500.0 kilo tons, which is expected to increase at a CAGR of 3.4% during the forecast period (2020). Out of which, household detergent industry accounted for more than half of the total market in 2014. The Asia-Pacific surfactant industry offers a potential opportunity for prominent players, owing to increasing population and rising demand for newer technologies and products from the developing regions. Improved lifestyle, increasing cost of living and rising population have fostered the adoption of surfactants in various industries, such as personal care, soaps & detergents, and pharmaceutical industry; thereby, boosting the growth of the surfactant industry.”

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| *(In thousands)*  |    | For the Nine Months Ended  |    |    |    |    |    |    |    |    |    |
|    |    | September 30, 2016  |    |    | September 30, 2015  |    |    | Increase (Decrease)  |    |    | Percent Change  |    |
| North America  |    | $  | 556,328  |    |    | $  | 563,119  |    |    | $  | (6,791  | )  |    |    | -1  |    |
| Europe  |    |    | 182,402  |    |    |    | 200,207  |    |    |    | (17,805  | )  |    |    | -9  |    |
| Latin America  |    |    | 109,881  |    |    |    | 112,050  |    |    |    | (2,169  | )  |    |    | -2  |    |
| Asia  |    |    | 50,403  |    |    |    | 45,748  |    |    |    | 4,655  |    |    |    | 10  |    |
| Total Surfactants Segment  |    | $  | 899,014  |    |    | $  | 921,124  |    |    | $  | (22,110  | )  |    |    | -2  |    |

Polymers Market Overview:

 “The global polymer industry is expected to grow with a CAGR of 3.9% over 2015-2020. The demand for polymer is driven by growth in end use markets, such as packaging, automotive, infrastructure, transport rails, and telecommunication mainly from emerging economies. On the basis of its comprehensive research, Lucintel forecasts that majority of the segments for the global polymer will have good growth during 2015-2020.”

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| *(In thousands)*  |    | For the Nine Months Ended  |    |    |    |    |    |    |    |    |    |
|    |    | September 30, 2016  |    |    | September 30, 2015  |    |    | Increase  |    |    | Percent Change  |    |
| North America  |    | $  | 245,292  |    |    | $  | 244,617  |    |    | $  | 675  |    |    |    | —  |    |
| Europe  |    |    | 118,706  |    |    |    | 116,049  |    |    |    | 2,657  |    |    |    | 2  |    |
| Asia and Other  |    |    | 18,542  |    |    |    | 17,037  |    |    |    | 1,505  |    |    |    | 9  |    |
| Total Polymers Segment  |    | $  | 382,540  |    |    | $  | 377,703  |    |    | $  | 4,837  |    |    |    | 1  |  |

Specialty Product Overview:

 “Specialty products, which accounted for five percent of consolidated net sales for the first half of 2016, include flavors, emulsifiers and solubilizes used in food, flavoring, nutritional supplement and pharmaceutical applications.”

**Valuation**

Absolute Valuation:

1. Dividend Discount Model:

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| --- | --- |
| 0.05525 | Geometric Average |
| 1.000154 | Logest |
| 0.057715 | Annualized Geometric Average |
| D1 |  $0.82  |
| P0 |  $80.86  |
| r | 6.79% |
| Div. Yield | 1.014% |

With a price at time (0) of $80.86 as of December 4, 2016 and a future dividend payment of $0.82 per share, an investor will receive a rate of return of 6.79% minimum.

Relative Valuation:

**Financial Analysis**

Stepan Company has been around since 1932, leaving for a lot of historical and financial data. Stepan Company is a counter cyclical stock, meaning the price tends to move in the opposite direction to the overall business cycle. If the market rises, then the stock price falls, and if the market falls, the price of the stock increases. This company has proven through several recessions to stay on a positive path, leaving proof that this firm is recession resistant. One of the main reasons why they are recession resistant is due to the products they manufacture and sell. People will always need cleaning supplies, polymers, and surfactants, so there is always a demand for these products. The current stock price of Stepan Company is sitting around $81, the highest it has been since 2012 when it hit $100 per share, and the company decided to do a 2:1 stock split. With the current trend of the stock price for Stepan Company, they are on pace to hit that $100 benchmark again, and could result in another 2:1 stock split very shortly.

 Over the past five years, Stepan Company has earned positive revenues, and remains right about the same total in those years. Although there has been a decrease over the past 3 years in total revenue, they are still producing numbers that are very close to one another and are on pace to increase that percentage at the end of 2016.

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| --- | --- | --- |
| Year | Revenue | Percent Change |
| 2011 | 46,542 | NA |
| 2012 | 48,017 | 3.1692% |
| 2013 | 46,854 | -2.4221% |
| 2014 | 45,998 | -1.8270% |
| 2015 | 44,294 | -3.7045% |

**Investment risk**

 There will always be risk in investing in any stock. Stepan Company has many investment risks in which the firm is worried about. High levels of inflation are always a concern for many firms. When inflation begins to increase, the dollar is worth less, and when an individual invests, that person will be purchasing a smaller percentage of a good or service due to the dollar not being valued as high.

 Fluctuations in foreign currency exchange rates can affect the demand of a product. If this happens, then the profitability in United States dollars gets negatively affected. Also, enforceability and compliances with United States laws can affect operations outside of the United States and can affect the foreign market mightily.

 As far as the international market is concerned, changes in foreign laws, regulations, and tax rates can affect how companies invest or expand their merchandise into the foreign industry. The market can change with respect to the foreign income and may unexpectedly increase the rate at which United States income is taxed, new taxes could be imposed and other additional taxes on remittances, repartition, or other payments by subsidiaries.

 As with any firm, political, financial, economic, and market conditions can be unstable. With the new president elect, things can change in a matter of time. New presidents mess with the market every four years due to the fact that any president can change the market at any point, and people listen to the media and react according to what the public thinks may be coming. Financial risk is the possibility of shareholders that will lose money when they invest. If nobody invests, then it puts the company at risk sometimes. Economic risk is the possibility of exchange rates, government regulation, or political stability can affect an investment. This can occur in the foreign market as well. Also, Changes in labor conditions and difficulties in staffing and managing international operations is another risk of Stepan Company.

 Trade and currency restrictions, which include currency exchange controls imposed by foreign countries. This is basically a governmental restriction on the movement of currency between countries. These are put into place by governments and central banks and they restrict the amount foreign currency or local currency in which can be traded or purchased.